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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Second Application by BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of In-Region, InterLATA Services in Louisiana	)	**CC Docket No. 98-121**

AFFIDAVIT

OF

ROBERT H. BORK

ON BEHALF OF

AT&T CORP.

AT&T EXHIBIT C

Filed August 4, 1998

FCC DOCKET CC NO. 97-231
AFFIDAVIT OF ROBERT H. BORK

TABLE OF CONTENTS

BEFORE THE
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In the Matter of	)	
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And BellSouth Long Distance, Inc.	)	
For Provision of In-Region, InterLATA	)	
Services in Louisiana	)	

AFFIDAVIT OF ROBERT H. BORK
ON BEHALF OF
AT&T CORP.

1. I, Robert H. Bork, am the John M. Olin Scholar in Legal Studies at the American Enterprise Institute for Public Policy Research. I received a B.A. and a J.D. from the University of Chicago. I am a former Circuit Judge on the United States Court of Appeals for the District of Columbia Circuit. I taught antitrust law for a number of years as a professor at the law school of Yale University and have written extensively in the field.

I. INTRODUCTION

2. BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc. (collectively "BellSouth") have filed an application with the Federal Communications Commission ("FCC") under Section 271 of the Communications Act, 47 U.S.C. § 271, seeking authority to provide in-region interexchange service in the State of Louisiana. BellSouth is presently barred from providing in-region interexchange service by 47 U.S.C. § 271(a), and will continue to be barred unless and until it receives the FCC's approval to begin providing such service.

3. After examining the issue and the arguments advanced by BellSouth, I conclude, as I have before, that the prohibition on BellSouth's provision of interexchange service is still supported by antitrust law and economic theory, and should be retained until there is sufficient facilities-based local competition in Louisiana to check the incentive and ability BellSouth would otherwise possess to impede both existing competition in the long-distance market and developing competition in local markets. The basic fact of the industry that required the prohibition in the first place, BellSouth's monopoly on local service within Louisiana, has not changed. The antitrust and economic reasoning that led to the restriction remain completely valid, and compel its continuation at this time.

4. Under Section 271(d)(3), the burden is on BellSouth to show that it meets the prerequisites for provision of in-region interexchange service, including the requirement that such entry be "consistent with the public interest." BellSouth has made no such showing.

5. The restriction is premised on two principal facts: BellSouth and the other BOCs have monopoly power in the local exchange, and regulatory mechanisms alone are insufficient to prevent the abuses of that power in the adjacent interexchange market that would harm consumers. Neither of those facts has changed.

6. I will first restate the antitrust and economic theory underlying the restriction on the provision of in-region interexchange service by BOCs, state the specific benefits which that restriction confers, and then examine BellSouth's contention that the theory no longer applies to the industry in Louisiana.

II. THE THEORY UNDERLYING THE RESTRICTION

7. The restriction on BOC provision of interexchange service was first established in the 1982 consent decree that settled the government's suit against the Bell System. That consent decree, as approved by the United States District Court for the District of Columbia, separated the BOCs from AT&T, leaving the former with monopolies of the exchange service in their local areas and the latter with long-distance service. As predicted, long-distance service quickly became competitive. There are now several national (and international) long-distance networks, which market aggressively against one another, and a number of regional networks. The local exchange networks, however, are monopolies, and consumer protection depends upon regulation to mitigate the effects of monopoly.

8. Antitrust describes the relationship between local and long-distance markets as vertical. A vertical relationship is simply one between a supplier and a customer. AT&T and other long-distance carriers purchase BellSouth's services in originating and completing long-distance calls.

9. Vertical integration, the union of a supplier and a customer within one corporate entity, is both very common and ordinarily beneficial. The courts and enforcement agencies have within the past fifteen or twenty years come to recognize that vertical integration rarely presents a problem. The reasons are simple. If the integrated firm is competitive in both markets, it cannot restrict output in order to raise prices and obtain monopoly profits. That being so, the only reason for the joinder of the supplying and the consuming firm is the expectation of increased efficiencies.

10. Nor does vertical integration pose any problem if the firm possesses monopoly in one or both markets. There is a single final price that maximizes a monopolist's net revenues. A monopoly in either market enables the vertically integrated firm to charge that price in the final market in which it sells. A company with a monopoly in the manufacture of widgets but operating as a competitor in the retailing of widgets could obtain full monopoly revenues by charging a monopoly price to its own and others' retail stores. The retail purchaser then pays the monopoly price, though the stores make only a competitive rate of return. If the firm obtains monopolies in both markets, it will still charge the same price. To charge monopoly prices in both markets would press the final price beyond the point of net revenue maximization. No firm would be foolish enough to charge a final price that decreased its revenues.

11. The situation and the conclusion change, however, when the monopoly level of the firm is regulated and the other level is, or could be, competitive. This situation so alters the firm's opportunities that antitrust can no longer view vertical integration as necessarily benign. That was the situation that led to the AT&T divestiture, and it is the situation that would be recreated if BellSouth's regulated monopoly were permitted to enter the competitive long-distance market. As a vertically integrated firm, BellSouth would be able to increase its revenues by damaging consumers in the monopolistic as well as the competitive markets.

III. BENEFITS OF THE RESTRICTION

12. The interexchange restriction prevents a return to the unsatisfactory situation that existed prior to the separation of local exchange services from long-distance service. Thus, it produces three major benefits.

A. Prevention of Access, Price, and Service Discrimination

13. The independent long-distance carriers are utterly dependent on the BOCs because almost all long-distance calls originate and terminate on a local exchange carrier's network. The absolute dependency of long-distance carriers on the BOCs creates the opportunity for BOCs that integrate into long-distance service while they continue to possess monopolies over local service to disadvantage independent long-distance carriers severely and perhaps decisively by the manner in which they price access to their networks and by delaying or degrading services on which long distance carriers depend.

14. BellSouth's application makes it sound as though detecting such tactics would be relatively simple. That is not the case. The telephone networks of the United States are almost endlessly complex; they are also evolving at high speed and always in the direction of greater complexity. Constant rapid change and increasing complexity mean that wide ranges of discretion are built into the design, pricing, and timing of the introduction of services and facilities offered by BOCs. It also means that the BOCs' exercise of that discretion would be largely beyond the ability of regulators to control. Currently, BellSouth has little incentive to use its discretion to harm long-distance carriers, but if allowed into long-distance markets it would have every incentive to do so.

15. BellSouth asserts that it wishes to enter long-distance in order to bring expertise and even more competition to that market. This analysis suggests, however, that it may have additional reasons. One reason may be to capture profits illegitimately through various forms of discrimination, including discrimination in pricing, in provisioning, and in the use of competitively important information.

16. Each BOC has hundreds of tariff provisions for connections between long-distance and local service. Each BOC, moreover, can file new tariffs at will, thus unilaterally changing any or all of the rates. The complexity and rapidly changing nature of this situation means that a BOC can present a moving target for regulators, filing discriminatory tariffs so that its long-distance affiliate pays less than independent long-distance carriers must pay. As technology and rates constantly change, new forms of discrimination will continually appear. That process can continue indefinitely.

17. At the moment, BOCs have every incentive to perform rapidly and efficiently in providing new services sought by long-distance carriers. A BOC with a long-distance affiliate, however, would have contrary incentives. In order to give its affiliate a competitive advantage, the BOC would have an incentive to delay the provision of new access services to independent long-distance carriers while provisioning its affiliate much more effectively. The BOC could, for example, simply assign its best technical teams to provide services to its affiliate while assigning less proficient employees to work for independent long-distance carriers. Regulators would be unable to detect this form of discrimination; there would be no benchmarks for a reasonable time of performance because new services would be involved.

18. There would be other mechanisms available for exploiting those monopolies as well. When an independent devises a new service, it must ask the BOCs to design access facilities to make that service possible. The BOCs require information about the technological details of the long-distance carrier's planned service, the customers to be targeted, the marketing plan, and much more. This is the kind of information that a long-

distance carrier carefully protects and would never give to a competitor. Yet when the carrier gives that information to a BOC integrated into the long-distance markets the carrier does give that information to a competitor. It would have no choice.

19. No statute or regulation prohibiting the transfer of such information to an affiliate can fully prevent that information from being misused. The ability of the BOC to pirate and use competitive information is greatly enhanced by the fact that there is no standard time for a BOC to design new facilities to accommodate new services. If the design is complex and sophisticated, as it often is, and if there are multiple options about the design, as is frequently the case, the process sometimes takes years. There is then a powerful incentive for the BOC to delay the provision of the necessary access to the independent carrier that invented the new service until its affiliate has the opportunity to develop a similar service. The affiliate will then be in a position to offer the service the independent developed simultaneously with or sooner than the independent.

20. Finally, in addition to creating incentives for a BOC to use its monopoly power to disadvantage its long-distance rivals in their provision of long-distance service, the vertical integration of a BOC into long-distance services would generate increased incentives to impede competition in its local markets. BellSouth contends, quite plausibly, that many customers would prefer "one-stop shopping" -- i.e., the opportunity to obtain local and long-distance service from a single provider. If that is so, a BOC could obtain powerful advantages in competing for those customers not only by disadvantaging independent long-distance carriers in their provision of long-distance services, but also by blocking or delaying their opportunities to compete in the local market. The same basic mechanisms for

discriminating against competitors would be available in that market as well, and any disincentives that a BOC might have to employ those mechanisms in order to build its case for long-distance entry would vanish once such entry were approved.

B. Prevention of Cross-Subsidization.

21. The problems created by allowing BellSouth to integrate vertically into long-distance service while it continues to possess a local monopoly do not by any means end with the question of discrimination. If the restriction were lifted, BellSouth could, as the government charged AT&T did, attribute some of the costs and expenses of its long-distance operations to its local exchange services. This would result in higher rates to those making local calls, because regulators allow local monopolies to cover their costs and expenses and make a profit. This tactic would also allow BellSouth to charge lower rates for long-distance calls, undercutting rivals in those markets that have no way of shifting costs elsewhere.

22. The opportunity to engage in this tactic arises from the joint nature of many costs in the telephone industry. Many of the costs of providing local service are incurred jointly with the provision of long-distance service or equipment -- or can be made to appear that way. Thus, under the FCC's rules, including its recent rules implementing the Section 272 separate subsidiary requirements, a BOC's property can be used for both local and long-distance service. Personnel will often perform services (such as administrative and marketing services) that benefit both kinds of offerings. Research and development, which is continuous, complex, and expensive will have benefits for both types of telephone service.

23. To the degree that state regulation of local telephone rates holds those rates below the full monopoly level, a BOC would have an incentive to misallocate long-distance

costs to local service. It could do so in several ways: by reporting costs that are solely attributable to its affiliate's long distance service as attributable to local service, by reporting costs that are jointly attributable to long distance and local service as solely attributable to local service, and by reporting costs that are solely attributable to long distance service as jointly attributable to both long distance and local service. By doing so, the BOC could force its local service to subsidize its affiliate's long distance service, pressing its local exchange rates toward the full monopoly level, while simultaneously obtaining a significant cost advantage over rivals in the competitive long-distance market.

24. Regulators have no way of reliably detecting and stopping abuses of this sort. The obstacles to effective prevention of these abuses are several. First, the cost manuals and costing systems generally used do not even address the measures of cost that regulators would need to determine whether cross-subsidy is occurring. A low priced service is cross-subsidized if the rate for the service fails to cover its marginal or average incremental cost. One service is cross-subsidizing another if the rate for the former service exceeds its stand-alone cost -- the cost an efficient new entrant would incur to provide the service without providing the low-priced services supplied by the incumbent. Existing regulatory systems, in contrast, are based on historical (book) costs, with joint costs allocated to individual services on the basis of arbitrary accounting conventions. The resulting cost data will equal the relevant costs only by accident.

25. Second, regulatory cost systems are highly dependant on the accurate categorization of individual expenses when initially entered into a BOC's account ledgers. If

an expense is misallocated at the outset, compliance with regulatory costing rules thereafter will not cure the misattribution.

26. The problem is made additionally unsolvable by other factors. Since facilities and services are constantly changing, prior cost levels would provide no measure of whether presently reported costs are excessive. Nor could regulators use the costs reported by other BOCs as benchmarks. Facilities, products, services, output mix, and other factors vary greatly among BOCs: different BOCs will be offering different services with different facilities. Moreover, such benchmarks would also be useless if the other BOCs were themselves permitted to provide long-distance service and shifting reported costs from long-distance to local service. Indeed, if a particular BOC were being underpriced in long-distance, state regulators would feel considerable pressure to accept cost data that made "their" BOC competitive in those markets.

27. The harms of cost shifting to competition in long-distance markets are predictable. By shifting reported costs from long-distance service to the local service rate base, vertically integrated BOCs would award themselves artificial pricing advantages over rivals in competitive markets -- thus obtaining a competitive advantage that would not be the result of greater efficiencies. They could either underprice their competitors or accomplish the same result by offering better service and products at the same price. The latter tactic would be particularly hard to detect.

28. State regulation of local rates would be impaired even if the cost shifting fell short of the literal cross-subsidy (as defined in ¶ 24). In allocating joint costs among individual services, state regulators typically balance a variety of public interest